Microsoft Corporation 1989 Annual Report

Microsoft

In 1975, Microsoft was founded on a vision—that someday there will be a computer on every desk and in every home.

Since then, our Company has grown to become the world's leading developer of personal computer software, with this year's revenues totaling more than $800 million.

While our Company has evolved, our vision has remained constant. Today, as in 1975, we continue to push technology forward, making products that help businesses operate more efficiently as organizations and help people perform more effectively as individuals.

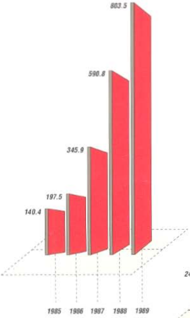
We believe in our software because we use it every day, for everything from managing our finances to writing and producing this annual report. In the process, we have become our own toughest critics, constantly challenging ourselves to design, develop, market, and manufacture better-quality products, more efficiently.

We're committed to excellence in everything we do; we're committed to quality in everything we produce. Our pledge is *Making it all make sense*™, a promise from our Company to serve as the voice of clarity in what we recognize can often be a confusing industry.

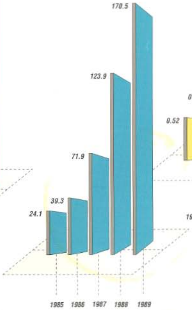
For our customers, this commitment means that we'll work to understand their businesses and deliver products that make them more productive. For our employees, it means we'll encourage innovation and participation throughout our organization. For our shareholders and the communities around the world in which we operate, it means we'll strive to do business in a way that rewards their trust in us and in our vision.

(In thousands, except net income per share)	Year Ended June 30				
	1989	1988	1987	1986	1985
For the year					
Net revenues	$803,530	$590,827	$345,890	$197,514	$140,417
Net income	170,538	123,908	71,878	39,254	24,101
Net income per share	3.03	2.22	1.30	0.78	0.52
At year-end					
Working capital	$310,131	$227,827	$164,353	$118,452	$41,442
Total assets	720,598	493,019	287,754	170,739	65,064
Stockholders' equity	561,780	375,498	239,105	139,332	54,440
Key ratios					
Current ratio	3.0	2.9	4.4	5.0	4.9
Return on net revenues	21.2%	21.0%	20.8%	19.9%	17.2%

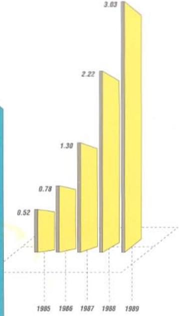
Net Revenues
(In millions)



Net Income
(In millions)



Net Income Per Share



To Our Shareholders:

It has been another record year for our Company, one in which we strengthened our position as the world's leading developer of personal computer software.

Revenues for the past twelve months equaled $803.5 million, a 36 percent increase over the $590.8 million recorded in fiscal 1988.

Net income and net income per share also reached higher-than-ever levels, in line with revenue growth. Net income rose to $170.5 million, up from $123.9 million last year, an increase of 38 percent. Net income per share rose 36 percent to $3.03, compared with $2.22 recorded last year.

These results reflect strong showings across all parts of our business, particularly in our International operations. During the fiscal year, combined International retail and OEM revenues represented 55 percent of the Company's total business, up from 48 percent last year. In addition, our Applications group has continued to grow as a total share of revenue.

Product Activity

Domestically, Microsoft shipped 53 new products or new versions of existing products during the year. Internationally, we released 256 localized versions of our software in 16 languages.

Systems products. The Systems group was responsible for several strategic introductions that are essential to the development of the next generation of personal computer hardware and software.

In October 1988, the Company delivered Operating System/2 (OS/2) version 1.1 to IBM. In subsequent months, similar on-schedule deliveries of the operating system were made to other OEMs.

This updated edition of OS/2 includes Presentation Manager, a visually oriented user interface that will serve as the face of computing throughout the 1990s and beyond. For several years, Microsoft has focused attention on the importance of visually based user interfaces to the growth of computing. OS/2 with Presentation Manager fully delivers on the promise of the new, more powerful personal computers, featuring a graphics-based design, pull-down menus, and the ability to integrate text and graphics effortlessly.

Several major companies have announced plans to develop products under the Microsoft® OS/2 Presentation Manager, including all five of the leading microcomputer software developers.

Also during the year, a variety of companies—including 3Com Corporation and Digital Equipment Corporation (DEC)—announced development plans or shipped products based upon the Microsoft LAN Manager, the advanced local area network environment that takes advantage of many advanced features of OS/2.

Our commitment to the advancement of technology does not mean that we are leaving behind our installed base of customers. Early in the fiscal year, we announced MS-DOS® operating system version 4.0, the updated edition of the most widely distributed operating system in the history of computing. We plan to continue making improvements to MS-DOS over the years ahead, as appropriate to the needs of the market.

Applications products. Many of our leading applications products were updated during the year, demonstrating our ongoing dedication to building the latest features of technology into our software.

In the spring, we began shipping new versions of Microsoft Word for both the IBM® and Apple® Macintosh® systems. Both products have been critically acclaimed and well received by the market, as demonstrated by their swift acceptance by dealers and end users. In fact, *Software Digest* has rated Microsoft Word for the PC and for the Macintosh as the top word processors in terms of performance, ease of learning, ease of use, error handling, and versatility.

We also released new versions of the Microsoft Excel spreadsheet for both the IBM and Macintosh environments, incorporating new features such as additional presentation and auditing capabilities.

New versions of Microsoft Mail, an electronic mail program,

and Microsoft Works, an integrated software program, were also released. In addition, we announced academic versions of several software products, offering fully functional industry-standard software at a competitive price that schools and students can afford.

Language products. Languages represented the first business of the Company, and they continue to play an important role in our product mix. Our Languages group was particularly active during the year, introducing the Microsoft QuickPascal Compiler for IBM and compatible personal computers; updated versions of Microsoft QuickBASIC for both IBM and Macintosh systems; as well as the Microsoft QuickC® Compiler, and the Microsoft COBOL and Microsoft FORTRAN Optimizing Compilers for IBM-compatible systems.

Hardware. Our hardware business, primarily through sales of the Microsoft Mouse pointing device, continued to grow throughout the year. Since its introduction in 1983, more than two million units of the Microsoft Mouse have been sold, with more than half those sales coming during the past fiscal year.

CD-ROM products. Several CD-ROM titles were released during the year, demonstrating our growing commitment to developing products that take advantage of a CD-ROM disc's capacity for storing enormous amounts of data. For example, the Microsoft Programmer's Library combines 72 books and manuals along with 26 megabytes of sample code on a single CD-ROM disc. The Microsoft Small Business Consultant represents a comprehensive collection of publications on all aspects of starting up and running a small business. And Microsoft Stat Pack brings together more than 220 publications on one disc, giving users quick and easy electronic access to a wealth of business research data.

Microsoft Press. Microsoft Press, the publishing, CD-ROM, and multimedia arm of the Company, released 50 new titles over the past year and once again produced record sales. Fourteen of

Jon A. Shirley William H. Gates

these books made the trade best-seller lists, including *Programming OS/2 Presentation Manager*, *Running Windows*, and *Desktop Publishing by Design*. Microsoft Press® books are printed in 15 languages and sold in more than 50 countries.

Microsoft Organization

The Company now employs more than 4000 people in over 25 locations around the world.

During the year, we completed a new 49,000-square-foot facility for our Product Support Services division, which incorporates the latest computer and telephone technology. This facility is designed to help our domestic Product Support group handle the more than 110,000 support calls received each month.

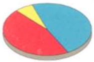
We also operate a 260,000-square-foot manufacturing facility located 20 minutes north of our corporate headquarters. This facility, along with a second plant in Dublin, Ireland, serves our worldwide manufacturing needs.

Several executives at the Company were promoted to senior vice president positions during the year. Steve Ballmer, senior vice president of systems software, joined Microsoft in 1980. Frank Gaudette, chief financial officer and senior vice president of finance and administration, has been with the Company since 1984. Jeremy Butler, who came on board in 1985 as director of European operations, is now senior vice president of international and OEM.

In other promotions, Bernard Vergnes, who has been with Microsoft since 1983, became vice president, Europe. He will head European operations from our new European headquarters in Paris. Paul Maritz, who has been with Microsoft for two and a half years, was promoted to the new position of vice president of advanced operating systems.

In an effort to streamline operations for increased efficiency, the Company reorganized two divisions during the year. The Applications division was restructured into business units, preparing it for expected growth over the next five years. The domestic and international OEM groups were combined under the International division, in recognition of the fact that the increasingly multinational character of our OEM customers requires centralized control of sales and operations.

Revenue by Product Group



1989

Systems/Languages	44%
Applications	42%
Hardware, Books, and Other	14%

1988

Systems/Languages	47%
Applications	40%
Hardware, Books, and Other	13%

Revenue by Channel

1989

Domestic OEM	14%
Domestic Retail	29%
International OEM	18%
International Retail	37%
Microsoft Press and Other	2%

1988

Domestic OEM	17%
Domestic Retail	32%
International OEM	14%
International Retail	34%
Microsoft Press and Other	3%

Business Activity

We have continued to work closely with other companies in a variety of strategic efforts. At the Company-sponsored Fourth International Conference on CD-ROM, we announced that we are working with IBM to create a new industry standard for developing multimedia computer systems. We announced plans to jointly develop with Hewlett-Packard a version of the Microsoft OS/2 Presentation Manager for the UNIX® operating system. We worked closely with Ashton-Tate Corporation and Sybase, Inc., to develop the Ashton-Tate®/Microsoft SQL Server, a multiuser relational database system, and shipped the Microsoft SQL Server Network Development Kit. And in April, Microsoft and Digital Communications Associates announced the DCA®/Microsoft Communications Server, a Microsoft LAN Manager–based communications product expressly designed for enterprise-wide connectivity.

In the lawsuit brought by Apple Computer, Inc., in March 1988 against Microsoft and Hewlett-Packard Company, which alleges that the visual displays in Microsoft Windows™ version 2.03 infringe certain Apple copyrights, the court ruled in a July 25, 1989 Memorandum of Decision and Order that the use of visual displays in Microsoft Windows 2.03 that are in Windows 1.0 and the five named applications programs is licensed under the November 1985 Settlement Agreement (between Microsoft and Apple). This means that 179, or almost 95 percent, of the 189 visual displays that Apple alleges are infringing, are no longer in the case. The remaining Windows 2.03 visual displays in question relate to overlapping main application windows and to icon appearances and manipulation. We expect the Court to proceed to determine whether or not Apple has a protectible and original interest in the pertinent Macintosh/Lisa® visual displays.

In summary, it has been another successful year for the Company. Our business is healthy and strong; we're optimistic about the future for our industry and for ourselves.

Over the short term, we expect that increased expenditures in research and development, along with higher sales and marketing expenses associated with our continuing shift to retail applications products, will cause an increase in operating expenses as a percent of revenues.

In addition, we will continue to invest in new technologies, such as multimedia products, that keep the Company at the forefront of our industry. These activities, we believe, are essential to realizing our long-term corporate strategies and continued growth.

This is a stimulating, challenging time. In many ways, we are at a pivotal point for our Company. During the past 24 months, we've delivered on the systems products that represent the foundation for the next generation of personal computing. Over the next 24 months, we will be delivering on the applications products that build upon this technology and put it to work.

In the next several pages, we will be describing the strategic building blocks that are behind our product development efforts in systems, applications, and networking. We think that, by reviewing these strategies, you will be able to better understand how some of the Company's individual product decisions fit into our broader vision.

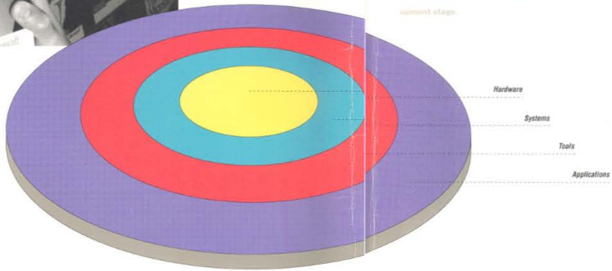
A vision, we believe, that puts us on the verge of the most exciting era in the history of personal computing.

Jon A. Shirley
President and
Chief Operating Officer

William H. Gates

William H. Gates
Chairman of the Board and
Chief Executive Officer

Microsoft's retail line of software includes top-rated applications products like Microsoft Word and Microsoft Excel, popular languages such as Microsoft QuickBASIC and QuickPascal, and professional languages such as Microsoft C.



► **Hardware.** Microsoft works closely with hardware manufacturers to define the shape of microprocessor and computer technology. And we ourselves manufacture one of the most popular hardware peripherals made today: the Microsoft Mouse.

► **Systems.** Microsoft systems software products—including the MS-DOS and MS OS/2 operating systems—now run on more than 30 million systems around the world.

► **Tools.** Microsoft languages and development tools (such as the Microsoft Presentation Manager Toolkit for developing OS/2 programs) help corporate and professional developers speed the creation of applications.

► **Applications.** Microsoft application products put computers to work in practical, everyday ways. The programs we develop are personal productivity applications—such as word processors, spreadsheets, and presentations products—designed for a broad range of users.

Computing in the 1990s

Personal computing—and Microsoft—are now entering a new decade.

What started as a niche industry set in a few high-tech corridors has become an international phenomenon—the cornerstone of how people everywhere do business.

The original needs of our industry have expanded as the technology has reached more people in more places.

For example, the enthusiast computer users of a decade ago didn't flinch at the arcane command structures that were built into many of the early applications programs. Instead, these "early adopters" embraced the technology, despite its frequent challenges.

Today, though, our customers find themselves considering a much broader base of potential users, and evaluating issues such as training costs and the relative efficiencies of one software platform versus another.

These are bigger issues than most companies faced in the 1980s, and they require proportionally bigger solutions.

As we enter the 1990s, we realize that we're in the midst of an important transition, a critical turning point in how we and our customers approach personal computing. To guide us through this transition, our Company has developed a comprehensive strategic plan designed to cover the wide range of evolving needs in the personal computer business.

This cohesive strategic plan goes well beyond the year-to-year issues inherent in the ongoing battles for market share. It is a long-term plan designed to carry us through the next era of personal computing, which will be more a quiet evolution than an overnight revolution.

But when we look back in the year 2000 and consider "Microsoft in its 25th year," this strategic plan, we believe, will be the foundation upon which we have built our success.

At Microsoft, we've carved out a unique position for our Company that cuts across the many facets of our industry, giving us an integral role at every development stage.

Strategy: Design a new generation of visually oriented software that allows *more* people to do *more* tasks *more* quickly with their personal computers.

The hardware advances of the past decade represent nothing less than a revolution of possibilities. A typical system of 1980, for example, had 48 kilobytes of memory. A typical system today comes with a megabyte of memory—more than 20 times as much. What's more, today's microprocessors are considerably faster than those of just a few years ago, and today's printers can produce output that was literally unimaginable at the start of the decade.

When we at Microsoft set out to harness all that power, we examined how we could make current computer users more productive while also making computers friendly and approachable enough to attract new users.

To accomplish both objectives, we developed two products for a visually oriented PC environment—the Microsoft Windows graphical environment and the Microsoft OS/2 Presentation Manager—which both include graphical devices and features that help people master their computers more quickly. (Some of these are described in the screen shot at right.)

More than just describing how a screen should *look*, these products redefine the *process* of how people use computers and, by extension, how software companies develop programs for them.

Three of the most important advantages of these environments are:

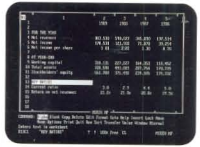
Consistent design across different products and different platforms. A user familiar with one application is well on the way to knowing all the others.

On-screen display of what the final document will look like. What users see on the screen matches what they'll get on paper, giving them a simpler, more direct view of their documents as they produce them.

Dynamic while-you-work dialogue. In place of convoluted and sometimes confusing system messages, our visually based software uses information boxes and pictures to establish a natural dialogue between the user and the machine.

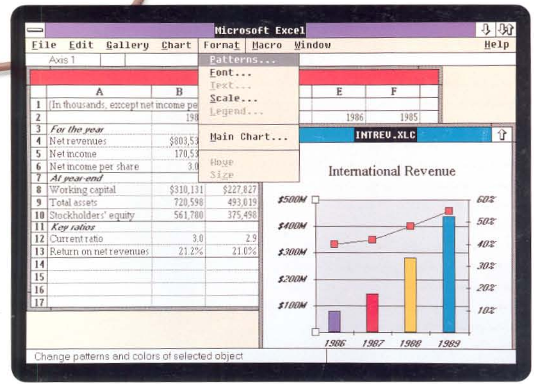
Because of its extensive display requirements, this software requires the computing muscle and extended memory of the new machines that have become available over the past couple of years, including those based upon the latest 16-bit and 32-bit microprocessors.

Today, both Microsoft Windows and the Microsoft OS/2 Presentation Manager feature a common design based on the IBM Systems Application Architecture™ (SAA) user-interface standards, putting the power of those new machines into the hands of the people who use them every day.



Character-based software—the computing standard of the first 15 years—is limited by its strict display requirements. For example, it does not display on screen how your printed document will appear. What's more, different commands work different ways in programs from different companies.

Microsoft Excel for Windows—the first major Windows-based application from Microsoft.



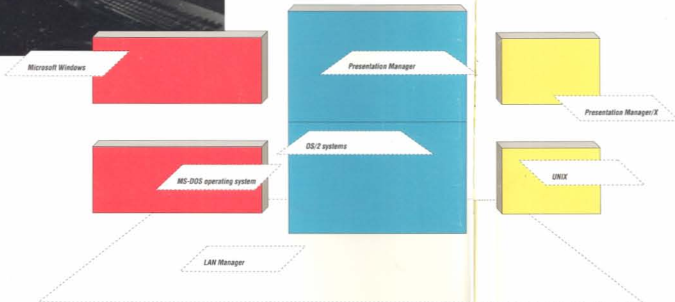
▶ Commands are readily available in pull-down menus, so you don't have to memorize complex keyboard sequences. Commands work the same way in every program.

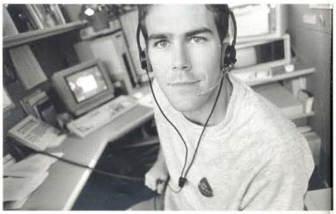
▶ On-screen display of type fonts and graphics matches what you'll see in the final printout.

▶ You can easily work with more than one document or program at a time, sharing information from one to the other—a particularly useful feature for preparing reports.

▶ Help is easy to get. You can ask for assistance on a single command or get a full tutorial about the program.

An operating system provides the platform on which applications products are built. Microsoft is designing visually based operating system solutions across three major development platforms: MS-DOS with Microsoft Windows; MS OS/2 with its fully integrated Presentation Manager; and Microsoft Presentation Manager/X, a combined effort from Microsoft and Hewlett-Packard to bring the Microsoft OS/2 Presentation Manager to the UNIX operating system. All these systems will be able to operate simultaneously under the Microsoft LAN Manager, which provides networking connectivity across all three environments.





Microsoft's Product Support Services group not only provides a service to our customers, but also helps us to better understand what customers need in products. For example, by tracking the calls coming in, we've concluded that graphics-based applications will require considerably less support than character-based software.

Strategy: Carry operating system technology forward to benefit our customers. Build on the past without being tethered to it.

When we set out to design the operating system that became Microsoft OS/2, we established a series of imperatives for ourselves:

Retain the best from MS-DOS. Most particularly, keep Microsoft OS/2 an open system, capable of running on a wide variety of machines from different manufacturers. Software developers appreciate the huge number of systems that MS-DOS represents. And corporations, we know, are looking for standards that give them the freedom to choose exactly the hardware they want, with the confidence that there will be a wide selection of software available that can run on those computers.

Advance the technical capabilities of the operating system. Through Microsoft OS/2, we're able to offer users a variety of new capabilities that are possible with today's new, more powerful hardware built around the Intel® 80286 and 80386 microprocessors—including the ability to manage large blocks of memory, run multiple applications simultaneously, and dynamically link information from one program to another.

Create a fully integrated, full-featured, visually oriented environment. One of our major goals in designing a new operating system was to weave all the multiple directions of personal computing together in a single place, where they could be integrated intelligently. Although some of the individual features of Microsoft OS/2 may be available singularly in other places, this is the only operating system that offers a single, consistent optimized platform that encompasses all these features in one place.

Our goal with the OS/2 operating system is to provide the platform on which the next generation of interactive graphics-based applications will be built. We firmly believe that this platform represents the future of personal computing, but as with the original IBM PC and with the Apple Macintosh, it may take time for the first applications to arrive that really exploit OS/2 features. Already, though, we see important signs of commitment. In fact, with the exception of MS-DOS itself, more hardware manufacturers have already signed up for Microsoft OS/2 than for any other single operating system.

Strategy: Create a line of application products that deliver on the potentials of the new technology, while providing ongoing support for existing customers.

Our applications business has grown steadily ever since we introduced our first application in 1982. Today, applications account for 42 percent of Microsoft's total revenues, and many of our applications products are award-winners that have been consistently rated high by reviewers and adopted by customers such as Arthur Andersen & Co.

As we look to the 1990s, our intention is clear—we intend to be the leader in graphics-based applications products. On the Macintosh side, we already are. We were the first to bring key Macintosh applications to market, and we continue to lead the Macintosh in the word processing, spreadsheet, presentation graphics, and integrated products categories, despite increasing competition.

We intend to be among the first to deliver graphics-based products on the PC side as well—as we've done with Microsoft Excel—building on our experience in both systems and applications products to create advanced state-of-the-art programs.

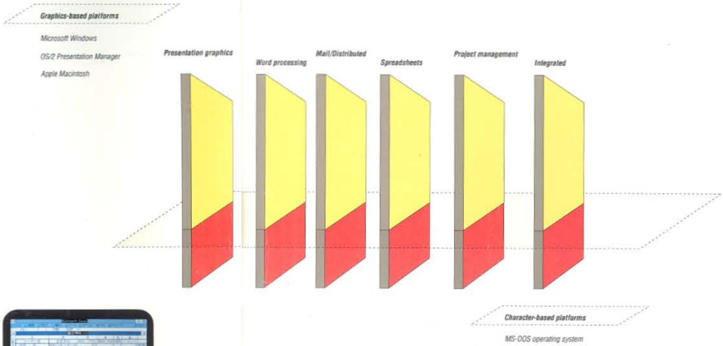
Several philosophies are at work behind these development efforts, including:

Consistency across multiple platforms. We will continue to develop software across multiple platforms: MS-DOS, Microsoft Windows, MS OS/2, and Macintosh. Our "core engine" approach to development means that the bulk of the code in a program can be transferred from one hardware platform to another, allowing us to get to market faster and at a lower cost while offering enhanced reliability and consistent program design to customers.

Data exchange and integration. The ability to exchange data effortlessly from one program to another greatly extends the power of each program involved. We design products so that this exchange can happen easily and dynamically not only from one program to another, but from one platform to another as well.

Enhanced usability. Microsoft has always been committed to providing customers with everything they need to make the most of our programs. We offer a collection of award-winning in-box training tools with every product, including encyclopedic documentation and on-line computer-based tutorials.

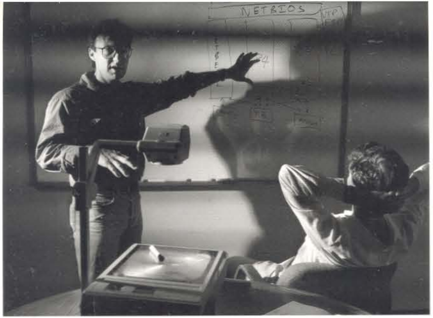
While we're in the midst of creating a new era in applications software, we recognize that there continues to be a huge market opportunity on the PC side with our current character-based applications. We intend to offer continuing support for that broad base of existing customers by providing regular updates of products as well as by building in ways for graphics-based and character-based products from multiple application developers to share files. In this way, we can continue to advance the state of the art while providing a migration path from the applications standards of today.



Japanese Kanji edition of Microsoft Excel and German version of Microsoft Word. Microsoft products are designed for quick localization, so we can quickly get new versions of products into the international market.

As part of our ongoing R&D efforts, the Company is investigating application product development opportunities across all of today's most popular platforms. These include the development of both depth products that serve as high-powered productivity tools, as well as integrated breadth products that offer several different applications in a single program. We plan to carry the knowledge gained from these investment efforts into future decisions about both systems and applications products.

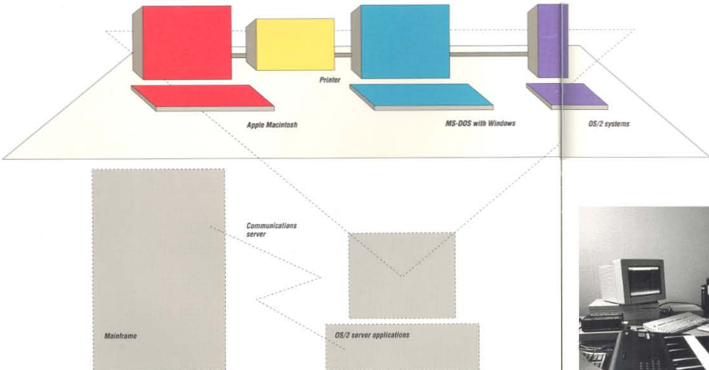
More than 1500 workstations at Manufacturers Hanover Trust are equipped with Microsoft Windows/386, running a variety of visually based applications that have been customized so employees never have to learn the intricacies of computers. For example, a user can get to Microsoft Word by selecting a command that says "Write A Memo." Loan officers evaluate risks and pricing by using Microsoft Excel, customized by macros, which changes all commands to reflect the standard language of their profession.



How a typical networking application might work, today and in the future:

Today. Several personal computer users linked together on a network can exchange electronic mail and share common resources such as printers. Through Microsoft Mail, files that contain graphics can be transferred as easily as text-only messages.

The future. That same network can also be used for advanced applications. Different members of a workgroup, for example, can draft, annotate, and edit a document, electronically and on-line. Or a group can share common information (for example, a customer list or sales data), getting quick access to the information. And all this can happen without either workgroup needing to know whether they're accessing a mainframe, a minicomputer, or a database residing on an independent file server.



Strategy: Develop effective tools for connectivity, carrying the power of personal computing from the desktop throughout the organization.

The role of the personal computer is changing.

"One person, one computer" was miracle enough just a few years ago. But as hardware evolves and the market grows, customers are beginning to realize that no computer is an island and that the interconnections of business require that the tools of business be interconnected, too.

Microsoft's vision was always ambitious—the idea of "a computer on every desk" suggests that people will want to share information and ideas from one desktop machine to another. So it's no surprise to us that local area networks (LANs) are among the fastest-growing segments in the computer business.

Whereas LANs were originally conceived as a way to make computers more cost effective by allowing expensive resources (such as printers) to be shared, the challenge of the 1990s is to use this technology to make people more productive by providing easy-to-use distributed applications. Our model of networking is built with an eye toward that future, with:

Multiple platforms and standard protocols. Recognizing that a wide variety of systems may be connected into a network—including MS-DOS, MS OS/2, Macintosh, UNIX, minicomputers, or mainframe systems—the Microsoft LAN Manager can support a range of different platforms and standard protocols so that everyone can have access to the information they need.

Client/server architecture. At the heart of workgroup computing, client/server architecture allows for a wide range of front-end "client" application programs to simultaneously share data residing on what will typically be a PC-based "server" system. The Ashton-Tate/Microsoft SQL Server makes it possible to centralize advanced computing resources on the server, so users can count on improved performance at their individual systems and a high level of data integrity throughout the network. They can also count on a consistent software design that will automatically allow them to get to the data they need via a wide variety of standard applications—not just with a single program designed exclusively for each specialized set of data.

What's more, because we utilize a common PC-based operating system on both the server and the workstation, software developers can optimize their development time and code, making it easier and faster for them to create network-based applications. And through the DCA/Microsoft Communications Server, individual local area networks can become an integral part of a corporate-wide area network, allowing organizations to make the most of their total company investment.

Strategy: Create a positive working environment for our employees, preparing us to take advantage of new markets, new technologies, and new opportunities.

Four years ago, Microsoft had fewer than 1000 employees. Today, we have 4000 located in more than 25 sites around the world.

As we've grown, we've tried to maintain a small-business feel in our operations, working in lean and efficient units that have discrete profit/loss responsibilities. We distribute decision-making responsibility to individual employees throughout the organization, giving people authority in their areas of expertise.

A good example of how this philosophy works can be seen in our international subsidiaries: fully independent businesses that make operational decisions locally. The benefits of this approach have shown up clearly on the bottom line. For the past several years, International has been the fastest-growing part of our business, and three of our subsidiaries—those in Germany, France, and Japan—are each large enough to rank among the top American personal computer software companies.

Similarly, over the past year we reorganized our Applications division into business units, with responsibility for a series of related products resting in each individual unit. This efficient mode of operation will, we believe, be particularly important over the next several years, as we commit increasing efforts to research and development.

Through it all—in the software we develop, in the way we organize our business, and in how we distribute and market our products—our emphasis remains squarely on the individual and on the *personal* side of personal computing.

That commitment to the individual has been at the foundation of our success since 1975. We believe it will continue to be the basis of a better future—for our employees, our Company, our shareholders, and our customers.

Microsoft's new facility in Munich, West Germany.

Microsoft's corporate campus is located on a wooded 155-acre site east of Seattle. Over the past year, we have added three new buildings and purchased more land to help us keep pace with our rapid rate of growth, and we're planning two more buildings for completion by the end of the next fiscal year.

Microsoft markets a complete line of business applications, language products, and hardware available from dealers worldwide. In addition to the products listed below, Microsoft markets many additional products—including the Microsoft OS/2, MS-DOS, and Microsoft XENIX® operating systems and the Microsoft LAN Manager—through hardware manufacturers worldwide.

	Operating System		
	OS/2 Systems	MS-DOS	Apple Macintosh
Business application software			
Microsoft Chart		▸	▸
Microsoft Excel	▸	▸	▸
Microsoft File			▸
Microsoft Learning DOS		▸	
Microsoft Mail		▸	▸
Microsoft Multiplan®	▸	▸	▸
Microsoft PowerPoint®			▸
Microsoft Project		▸	
Microsoft Word	▸	▸	▸
Microsoft Works		▸	▸
Microsoft Write			▸
The Microsoft Office			▸
Systems/Languages software			
Microsoft BASIC	▸	▸	
Microsoft C	▸	▸	
Microsoft COBOL	▸	▸	
Microsoft FORTRAN	▸	▸	
Microsoft Macro Assembler	▸	▸	
Microsoft Pascal		▸	
Microsoft QuickBASIC		▸	▸
Microsoft QuickC Compiler		▸	
Microsoft QuickC Compiler with QuickAssembler		▸	
Microsoft QuickPascal		▸	
Microsoft Windows/286		▸	
Microsoft Windows/386		▸	
Hardware, Recreation, and CD-ROM products			
Microsoft Mouse	▸	▸	
Microsoft Flight Simulator®		▸	▸
Microsoft Bookshelf (CD-ROM)		▸	
Microsoft Programmer's Library (CD-ROM)		▸	
Microsoft Small Business Consultant (CD-ROM)		▸	
Microsoft Stat Pack (CD-ROM)		▸	

Microsoft Press books

Microsoft Press publishes more than 100 titles on software, computers, and science and technology under both the Microsoft Press and Tempus imprints. Titles are distributed through standard bookstore outlets as well as through computer and software stores.

Microsoft Corporation 1989 Financial Results

(In millions)

Net Revenues

	1989	Change	1988	Change	1987
Net revenues	$803.5	36%	$590.8	71%	$345.9

The Company's annual revenues are influenced by several factors, including growth of worldwide personal computer hardware shipments, the introduction of new products, the enhancement and localization of existing products, and the expansion of the Company's international operations to new geographic areas. Volume, as opposed to price increases, has been the principal factor in the Company's revenue growth.

During 1989, the growth of worldwide personal computer hardware shipments was more moderate than in 1988 and 1987. Although 1989's revenues benefited from the enhancement and localization of existing products, new products did not contribute as significantly to revenue growth as in 1988, when they accounted for approximately 10% of revenues.

International revenues continued to contribute significantly to the Company's growth. These revenues were $438.3 million, $282.3 million, and $146.2 million in 1989, 1988, and 1987, increasing 55% from 1988 to 1989 and 93% from 1987 to 1988. The 1989 growth reflects product localizations and the increased prominence of several international OEMs. The 1988 growth was affected by further expansion of operations in Europe and Asia and favorable foreign currency exchange rates.

Revenues collectible in foreign currencies represented 35.4%, 32.4%, and 27.0% of total revenues in 1989, 1988, and 1987. Consequently, the Company's operating results are affected by fluctuation of foreign currency exchange rates. For 1989, when the U.S. dollar strengthened, the Company's 36% revenue increase consisted of a 38% operational increase less a 2% exchange rate impact. For 1988, when the U.S. dollar weakened, the Company's 71% revenue increase consisted of a 65% operational increase plus a 6% exchange rate increase. The net income impact of such fluctuations is offset to the extent costs and expenses of the Company's international operations are incurred in the same currencies as its revenues. For additional information concerning international operations, see page 33.

Cost of Revenues

	1989	Change	1988	Change	1987
Cost of revenues	$204.2	38%	$148.0	100%	$73.9
Percentage of net revenues	25.4%		25.0%		21.4%

As a percentage of net revenues, cost of revenues for 1989 did not differ significantly from 1988. The 1988 increase as a percentage of net revenues was a result of numerous factors, including a shift in the revenue mix to a greater contribution from packaged products, a significant increase in lower profit margin revenue from product updates, an increase in product material costs, and price reductions on select products due to strategic or competitive factors.

Operating Expenses

	1989	Change	1988	Change	1987
Research and development	$110.2	58%	$69.8	83%	$38.1
Percentage of net revenues	13.7%		11.8%		11.0%
Sales and marketing	$219.0	36%	$161.6	90%	$85.1
Percentage of net revenues	27.3%		27.4%		24.6%
General and administrative	$27.9	16%	$24.0	9%	$22.0
Percentage of net revenues	3.5%		4.1%		6.4%

The 1989 increase in research and development expenses as a percentage of net revenues is a result of planned additions to the Company's software development staff and expenses relating to product localization. As of June 30, 1989, the Company employed 1,288 people in product research and development. This figure is up 57% from the 822 employed in product research and development as of June 30, 1988. The 1988 increase is also attributable to staff additions and product localization. Management anticipates that research and development expenses will continue to increase as a percentage of net revenues in 1990.

The 1989 increase in sales and marketing expenses reflects the continuing expansion of the Company's domestic and international sales, marketing, and support staff, and increased advertising and marketing expenditures. As a percentage of net revenues, sales and marketing expenses for 1989 did not differ significantly from 1988. Further, the 1988 results were affected by increased cooperative marketing and promotional activities. For 1990, management anticipates that sales of retail applications products will represent a greater percentage of the Company's business. This sales mix shift will require more sales and support staff, and increased advertising and marketing expenditures. Consequently, management anticipates that sales and marketing expenses will increase as a percentage of net revenues in 1990.

The increase in general and administrative expenses, although not in proportion to the increases in net revenues, is primarily attributable to the growth in administrative staff and systems necessary to support the overall increase in the scope of the Company's operations.

Non-operating Income

	1989	Change	1988	Change	1987
Non-operating income	$16.6	54%	$10.8	24%	$8.6
Percentage of net revenues	2.1%		1.8%		2.5%

Non-operating income includes investment income of $18.8 million, $8.7 million, and $7.3 million in 1989, 1988, and 1987. Growth in investment income is attributable to a larger investment portfolio resulting from funds generated from operations. Results also include foreign currency transaction gains of $2.5 million and $1.7 million in 1988 and 1987.

Stock Option Program Expense

	1989	Change	1988	Change	1987
Stock option program expense	$8.0	(45)%	$14.5	2%	$14.2
Percentage of net revenues	1.0%		2.4%		4.1%

Stock option programs were adopted by the Company in 1987 in response to the Tax Reform Act of 1986. As discussed in Note 9 of Notes to Consolidated Financial Statements, under these programs employees are paid a cash payment based on tax benefits the Company receives when the employees sell certain option stock or exercise certain options after having agreed to changes in the options' tax attributes.

As required by generally accepted accounting principles, the tax benefit realized from these programs is reported as a capital contribution. The cash payments under these programs, offset by direct income tax reduction, are recognized as expense over the vesting period of the related stock options. The effect of the programs on the accompanying financial statements is shown in Note 9 of Notes to Consolidated Financial Statements. The 1989 decrease in stock option program expense is a result of a decrease in the number of option shares vesting that are subject to the program.

Through June 30, 1989, the cumulative net benefit realized from these programs was $30.2 million. The benefit yet to be received depends primarily upon the market value of the Company's common stock. At current stock values of $50 to $60 per share, the benefit yet to be received will be approximately $10 million through 1992, resulting in a cumulative net benefit of approximately $40 million.

Provision for Income Taxes

	1989	Change	1988	Change	1987
Provision for income taxes	$80.3	34%	$59.8	21%	$49.5
Percentage of net revenues	10.0%		10.1%		14.3%
Effective tax rate	32.0%		32.6%		40.8%

For an analysis of the differences between the statutory and the effective income tax rates, see Note 8 of Notes to Consolidated Financial Statements. The decrease in the effective tax rate for 1988 results from the Tax Reform Act of 1986, which lowered the top corporate tax rate from 46% to 34%.

In December 1987, the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 96—Accounting for Income Taxes*. In December 1988, the Board deferred the effective date of the Statement, which is now effective for the Company's fiscal year ending June 30, 1991. The Statement requires an asset and liability approach for accounting for income taxes. Deferred tax liabilities are adjusted for the effect of a change in tax law or rates. The Statement is also more restrictive in the recognition of deferred tax assets. Financial statements for fiscal years before the effective date may be restated for the effects of the Statement. Adoption of the Statement is not currently expected to have a material effect on the financial statements.

Net Income and Net Income Per Share

	1989	Change	1988	Change	1987
Net income	$170.5	38%	$123.9	72%	$71.9
Percentage of net revenues	21.2%		21.0%		20.8%
Net income per share	$3.03	36%	$2.22	71%	$1.30

Had the one-time stock option programs discussed above not been adopted, net income and net income per share would have been as follows:

	1989	Change	1988	Change	1987
Pro forma net income	$175.3	32%	$132.8	70%	$78.1
Percentage of net revenues	21.8%		22.5%		22.6%
Pro forma net income per share	$3.12	31%	$2.38	70%	$1.40

Microsoft Corporation Consolidated Statements of Income

(In thousands, except net income per share)

	Year Ended June 30		
	1989	1988	1987
Net revenues	$803,530	$590,827	$345,890
Cost of revenues	204,185	148,000	73,854
Gross profit	599,345	442,827	272,036
Operating expenses:			
Research and development	110,220	69,776	38,076
Sales and marketing	218,997	161,614	85,070
General and administrative	27,898	23,990	22,003
Total operating expenses	357,115	255,380	145,149
Operating income	242,230	187,447	126,887
Non-operating income (Note 1)	16,566	10,750	8,638
Stock option program expense (Note 9)	(8,000)	(14,459)	(14,187)
Income before income taxes	250,796	183,738	121,338
Provision for income taxes (Note 8)	80,258	59,830	49,460
Net income	$170,538	$123,908	$ 71,878
Net income per share (Note 1)	$ 3.03	$ 2.22	$ 1.30

See accompanying notes

(In millions)

115b 130 65 80

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Liquidity and Capital Resources

	1989	Change	1988	Change	1987
Cash and short-term investments	$300.8	64%	$183.2	38%	$132.5
Cash from operations	$222.5	99%	$111.7	89%	$59.1
Working captial	$310.1	36%	$227.8	39%	$164.4
Current ratio	3.0		2.9		4.4

In the following discussion, which is based on the Consolidated Statements of Cash Flows, certain amounts do not agree with changes in the Consolidated Balance Sheets due to the effect of exchange rate changes.

Fiscal 1989

During 1989, cash and short-term investments grew $117.6 million to $300.8 million and comprised 64% of current assets and 42% of total assets at June 30, 1989.

Net cash from operations during 1989 totaled $222.5 million, of which $194.7 million resulted from net income plus non-cash depreciation and amortization. Other significant sources were an increase in current liabilities, excluding notes payable, of $37.9 million and a decrease in inventories of $14.7 million. The increase in current liabilities is a result of an increase in income taxes payable by several of the Company's subsidiaries and of the overall growth in the Company's operations. The decrease in inventories is a result of improved sales forecasts and tighter inventory controls. The only significant use of net cash from operations was an increase in accounts receivable of $20 million. This increase reflects higher fourth quarter revenue in 1989, as days' sales in accounts receivable decreased from 49 days at June 30, 1988 to 45 days at June 30, 1989.

Net cash from financing during 1989 totaled $25.5 million. Proceeds from the sale of common stock under the Company's stock option and employee stock purchase plans, and related income tax benefits, accounted for $20.4 million of this total. Borrowings under subsidiary operating lines account for the majority of the remainder.

Excluding short-term cash investments, net cash used for investments during 1989 totaled $129.4 million, of which $89.4 million was used for additions to property, plant, and equipment. In October 1988, the Company completed construction on a 235,000-square-foot office expansion to the corporate campus in Redmond, Washington. The cost of this expansion totaled approximately $30 million, of which approximately $20 million was expended in 1989. In January 1989, the Company began construction on an 84,000-square-foot data center on its corporate campus. Through June 30, 1989, construction costs on this data center facility, which is expected to be completed in September 1989, totaled approximately $8 million. Purchases of computer equipment, including both personal and corporate systems, totaled approximately $43 million during 1989. Other significant uses were a minority investment of $19.9 million in The Santa Cruz Operation, Inc. and the acquisition of intellectual property rights totaling $12 million (see Note 5 of Notes to Consolidated Financial Statements).

Management anticipates that, barring unforeseen circumstances or events, the Company's operations will continue to generate the liquidity necessary to meet its needs. Future expansion of facilities at its corporate campus and various foreign locations is anticipated in order to accommodate growth in the Company's business.

In addition to completion of the data center, current corporate campus expansion plans include construction of a 117,500-square-foot office building at an expected cost of approximately $18 million. Construction of this facility began in July 1989 and is expected to be completed in April 1990. Upon completion of this office building, corporate campus building space owned or under long-term lease will total approximately 870,000 square feet. The Company's commitments for additional facilities totaled approximately $5 million at June 30, 1989.

In July 1989, the Company agreed in principle to purchase land and office space adjacent to its corporate campus for approximately $18 million. The purchase is expected to close in August 1989.

Fiscal 1988

During 1988, cash and short-term investments grew $50.7 million to $183.2 million and comprised 53% of current assets and 37% of total assets at June 30, 1988.

Net cash from operations during 1988 totaled $111.7 million. Net income plus non-cash depreciation and amortization of $139.9 million and an increase in current liabilities, excluding notes payable, of $54.1 million, offset by increases in accounts receivable of $38.9 million and inventories of $37.2 million, accounted for the majority of this net cash provided figure. The increase in current liabilities was a result of numerous factors, including an increase in income taxes payable by several of the Company's subsidiaries, accruals associated with the stock option programs, and the overall growth in the Company's operations. The increase in accounts receivable reflected higher fourth quarter revenue in 1988, as days' sales in accounts receivable decreased from 50 days at June 30, 1987 to 49 days at June 30, 1988. The increase in inventories was the result of several factors, including a significant increase in worldwide retail operations, an expansion of the Company's product line through addition of new products and product enhancements, the completion and occupancy of a new domestic manufacturing and distribution facility, and the establishment of additional foreign subsidiaries with warehouses.

Net cash from financing during 1988 totaled $28.3 million. Borrowings in connection with the Company's foreign currency hedging program accounted for $15.1 million of this total. Proceeds from the sale of common stock under the Company's stock option and employee stock purchase plans, and related income tax benefits, accounted for the remainder.

Excluding short-term cash investments, net cash used for investments during 1988 totaled $89.2 million, of which $71.8 million was used for additions to property, plant, and equipment, and $12.4 million was used to acquire intellectual property rights. In March 1988, the Company completed construction of a 260,000-square-foot manufacturing and distribution facility in Snohomish County, Washington, at a cost of $10.5 million. In addition, the Company purchased equipment for this facility at a cost totaling $5.7 million. Also in March 1988, the Company began construction on a 235,000-square-foot office expansion to the corporate campus in Redmond, Washington. Through June 30, 1988, construction costs of this office expansion totaled approximately $10 million. In May 1988, the Company purchased undeveloped land adjacent to its corporate campus for $9.4 million. Purchases of computer equipment, including both personal and corporate systems, totaled approximately $24.3 million during 1988.

Microsoft Corporation Consolidated Balance Sheets

(In thousands)

	June 30	
	1989	1988
Assets		
Current assets:		
Cash and short-term investments (Note 2)	$300,791	$183,225
Accounts receivable—net of allowance of $14,694 and $11,120	111,180	93,602
Inventories (Note 3)	37,755	53,542
Other	19,223	14,979
Total current assets	468,949	345,348
Property, plant, and equipment - net (Note 4)	198,825	130,108
Other assets (Note 5)	52,824	17,563
Total assets	$720,598	$493,019
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 41,953	$ 43,112
Customer deposits and deferred revenue	10,043	6,038
Accrued compensation and employee benefits	25,718	15,057
Notes payable (Note 7)	25,419	20,259
Income taxes payable	30,269	16,051
Other	25,416	17,004
Total current liabilities	158,818	117,521
Commitments and contingencies (Notes 4, 6, 9, and 11)	—	—
Stockholders' equity (Note 10):		
Common stock—$.001 par value; shares authorized 160,000; issued and outstanding 54,586 and 53,663	55	54
Paid-in capital	110,425	90,046
Retained earnings	455,552	285,014
Translation adjustment	(4,252)	384
Total stockholders' equity	561,780	375,498
Total liabilities and stockholders' equity	$720,598	$493,019

See accompanying notes

(In thousands)

	Common Stock		Paid-in Capital	Retained Earnings	Translation Adjustment	Total Stockholders' Equity
	Shares	Amount				
Balance, June 30, 1986	51,040	$51	$ 50,767	$ 89,228	$ (714)	$139,332
Sale of stock	1,673	2	1,696	—	—	1,698
Income tax benefit related to stock options (Note 9)	—	—	24,348	—	—	24,348
Net income	—	—	—	71,878	—	71,878
Translation adjustment	—	—	—	—	1,849	1,849
Balance, June 30, 1987	52,713	53	76,811	161,106	1,135	239,105
Sale of stock	950	1	1,681	—	—	1,682
Income tax benefit related to stock options (Note 9)	—	—	11,554	—	—	11,554
Net income	—	—	—	123,908	—	123,908
Translation adjustment	—	—	—	—	(751)	(751)
Balance, June 30, 1988	53,663	54	90,046	285,014	384	375,498
Sale of stock	923	1	6,281	—	—	6,282
Income tax benefit related to stock options (Note 9)	—	—	14,098	—	—	14,098
Net income	—	—	—	170,538	—	170,538
Translation adjustment	—	—	—	—	(4,636)	(4,636)
Balance, June 30, 1989	54,586	$55	$110,425	$455,552	$(4,252)	$561,780

See accompanying notes

(In thousands)

	Year Ended June 30		
	1989	1988	1987
Cash flows from operations			
Net income	$170,538	$123,908	$71,878
Depreciation and amortization	24,191	16,035	7,551
Current liabilities, excluding notes payable	37,857	54,064	13,265
Accounts receivable	(20,004)	(38,864)	(19,665)
Inventories	14,660	(37,169)	(8,098)
Other current assets	(4,766)	(6,232)	(5,827)
Net cash from operations	222,476	111,742	59,104
Cash flows from financing			
Notes payable	5,160	15,087	3,293
Common stock issued	6,282	1,682	1,698
Income tax benefits related to stock options (Note 9)	14,098	11,554	24,348
Net cash from financing	25,540	28,323	29,339
Cash flows from investments			
Additions to property, plant, and equipment (Note 4)	(89,362)	(71,794)	(57,644)
Investment in The Santa Cruz Operation, Inc. (Note 5)	(19,900)	—	—
Acquisition of intellectual property rights	(12,049)	(12,427)	—
Short-term investments	(15,656)	(23,156)	(42,406)
Other	(8,063)	(4,929)	(1,420)
Net cash used for investments	(145,030)	(112,306)	(101,470)
Net change in cash and equivalents before effect of exchange rate changes on cash and equivalents	102,986	27,759	(13,027)
Effect of exchange rate changes on cash and equivalents	(1,076)	(174)	429
Cash and equivalents at beginning of year	90,478	62,893	75,491
Cash and equivalents at end of year (Note 2)	$192,388	$ 90,478	$62,893

For the years ended June 30, 1989, 1988, and 1987, interest payments were $2.1 million, $1.5 million, and $830,000 and income taxes paid were $51.9 million, $32.4 million, and $31.9 million. Certain amounts in the Consolidated Statements of Cash Flows do not agree with changes in the Consolidated Balance Sheets due to the effect of exchange rate changes.

See accompanying notes

Report of Management

Management is responsible for the preparation of the Company's consolidated financial statements and related information appearing in this annual report. Management believes that the consolidated financial statements fairly reflect the form and substance of transactions and that the financial statements reasonably present the Company's financial condition and results of operations in conformity with generally accepted accounting principles. Management has included in the Company's financial statements amounts based on estimates and judgments that it believes are reasonable under the circumstances.

The independent accountants audit the Company's consolidated financial statements in accordance with generally accepted auditing standards and provide an objective, independent review of the fairness of reported operating results and financial position.

The Board of Directors of the Company has an Audit Committee composed of non-management Directors. The Committee meets with financial management and the independent accountants to review accounting, auditing, internal accounting controls, and financial reporting matters.

Francis J. Gaudette

Francis J. Gaudette
Senior Vice President, Finance and Administration; Treasurer; Chief Financial Officer

Report of Independent Accountants

To the Board of Directors and Stockholders of Microsoft Corporation:

We have audited the accompanying consolidated balance sheets of Microsoft Corporation and subsidiaries as of June 30, 1989 and 1988, and the related consolidated statements of income, stockholders' equity, and cash flows for each of the three years in the period ended June 30, 1989. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Microsoft Corporation and its subsidiaries as of June 30, 1989 and 1988, and the results of their operations and their cash flows for the years then ended in conformity with generally accepted accounting principles.

Deloitte Haskins + Sells

Deloitte Haskins & Sells
Bellevue, Washington
July 25, 1989

Note 1. Significant Accounting Policies

Business. The Company's principal business activities are the development, production, marketing, and support of a wide range of software for business and professional use, including operating systems, languages and application programs, as well as books and hardware for the microcomputer marketplace.

Principles of Consolidation. The consolidated financial statements include the accounts of Microsoft and its wholly owned subsidiaries. Significant intercompany transactions and balances have been eliminated.

Foreign Currency Translation. Assets and liabilities denominated in foreign currencies are translated to U.S. dollars at the exchange rate on the balance sheet date. Revenues, costs, and expenses are translated at average rates of exchange prevailing during the year. Translation adjustment resulting from this process is shown separately in stockholders' equity.

Exchange adjustments resulting from foreign currency transactions and realized and unrealized gains and losses on forward contracts used to hedge currency fluctuations are included in non-operating income. At June 30, 1989, the Company had approximately $46 million in contracts to exchange currency in the future.

Revenue Recognition. Revenue from sales of software and hardware consumer products to distributors or dealers is recognized when the products are shipped. Software products sold to original equipment manufacturers under license agreements generally provide for a commitment fee payable over a minimum commitment period of one to three years. When the product is accepted, the commitment fee is recognized as revenue ratably over the minimum commitment period or on a per unit basis if sales exceed the commitment fee level. Subsequent to the minimum commitment period, revenue based upon the number of systems shipped or copies sold is recognized as earned. Commitment fees received prior to product acceptance are recorded as customer deposits.

Warranties and Exchanges. The Company warrants products against defects and has policies permitting distributors and dealers to exchange products under certain circumstances. The Company's policies do not permit return of products to the Company for credit or refund. The Company's reserve for warranties and exchanges was $10.9 million and $4.5 million at June 30, 1989 and 1988.

Research and Development. A Financial Accounting Standards Board statement requires the capitalization of certain costs of producing software. Such costs are immaterial. Other research and development costs are expensed as incurred.

Royalty Costs. Cost of revenues includes royalties paid to authors of certain software products and publications under license agreements. Such royalties, which are based on net revenues, were $14 million, $11.4 million, and $9.8 million for the years ended June 30, 1989, 1988, and 1987.

Income Taxes. Income tax expense includes United States and foreign income taxes, including United States taxes on undistributed earnings of foreign subsidiaries. Certain items of income and expense included in the consolidated financial statements are reported in different years in the tax returns in accordance with applicable income tax laws. The resulting difference between the consolidated financial statement income tax provision and income taxes currently payable is reported in the consolidated financial statements as deferred income taxes. Tax credits are accounted for as a reduction of tax expense in the year in which the credits reduce taxes payable.

In 1987, the Financial Accounting Standards Board issued *Statement of Financial Accounting Standards No. 96—Accounting for Income Taxes*, a new pronouncement on accounting for income taxes which is not required to be adopted by the Company until its fiscal year ending June 30, 1991. The Company has not decided whether it will adopt this accounting pronouncement prior to the required date, but adoption is not currently expected to have a material effect on the financial statements.

Non-operating Income. Non-operating income includes investment income of $18.8 million, $8.7 million, and $7.3 million for the years ended June 30, 1989, 1988, and 1987. Such amounts are net of interest expense of $2.3 million, $1.5 million, and $830,000 for fiscal years 1989, 1988, and 1987. Interest expense is incurred primarily on loans used to hedge foreign currency exposure. Results also include foreign currency transaction gains of $2.5 million and $1.7 million for the years ended June 30, 1988 and 1987.

Net Income Per Share. Net income per share is computed on the basis of the weighted average number of common and common equivalent shares outstanding and is adjusted for shares issuable upon exercise of stock options. The computation assumes the proceeds from the exercise of stock options were used to repurchase common shares at the average market price of the Company's common stock during each period. Such average shares outstanding were 56,245,000, 55,818,000, and 55,270,000 for the years ended June 30, 1989, 1988, and 1987.

Short-term Investments. Short-term investments are stated at the lower of cost or market.

Inventories. Inventories are stated at the lower of cost or market. Cost is determined using the first-in, first-out method.

Property, Plant, and Equipment. Property, plant, and equipment is stated at cost and depreciated using straight-line and declining-balance methods over estimated useful lives. Such lives are:

Buildings	30 - 35 years
Leasehold improvements	Lease term
Furniture and equipment	5 years
Computer equipment	5 years

Notes Receivable from Sales of Stock. Notes receivable arising from capital stock transactions with officers of the Company, which are immaterial, are accounted for as deductions from stockholders' equity.

Statement of Cash Flows. In 1989, the Company adopted *Statement of Financial Accounting Standards No. 95—Statement of Cash Flows*, which requires a statement of cash flows in place of a statement of changes in financial position. Previously reported statements of changes in financial position for 1988 and 1987 have been replaced with statements of cash flows to conform with the 1989 presentation.

Note 2. Cash and Short-term Investments

The Company considers all highly liquid investments with a maturity of three months or less at the date of purchase to be cash equivalents. Cash and short-term investments at June 30, 1989 and 1988 consist of the following:

(In thousands)	June 30 1989	1988
Cash and equivalents:		
Cash	$ 30,624	$ 5,144
Bank loan participations	49,250	7,230
Repurchase agreements	10,680	11,189
Money market preferreds	101,834	66,915
Cash and equivalents	192,388	90,478
Short-term investments:		
Corporate bonds	4,049	5,719
Increasing rate notes	21,126	38,172
Municipal securities	83,228	48,856
Short-term investments	108,403	92,747
Cash and short-term investments	$300,791	$183,225

Note 3. Inventories

Inventories at June 30, 1989 and 1988 were as follows:

(In thousands)	June 30 1989	1988
Raw materials and work in process	$17,695	$28,477
Finished goods	20,060	25,065
	$37,755	$53,542

Note 4. Property, Plant, and Equipment

Property, plant, and equipment at June 30, 1989 and 1988 were as follows:

(In thousands)	June 30 1989	1988
Land	$ 41,465	$ 41,418
Buildings	68,828	37,151
Leasehold improvements	10,215	6,101
Furniture and equipment	29,933	20,792
Computer equipment	98,224	54,777
	248,665	160,239
Accumulated depreciation	(49,840)	(30,131)
Property, plant, and equipment—net	$198,825	$130,108

In July 1989, the Company agreed in principle to purchase land and office space adjacent to its corporate campus for approximately $18 million. The purchase is expected to close in August 1989.

Note 5. Other Assets

Intellectual Property Rights. Other assets include intellectual property rights of $15.5 million and $7.9 million at June 30, 1989 and 1988. Such amounts are stated at cost ($24.5 million and $12.4 million) less accumulated amortization ($9 million and $4.5 million). Amortization expense is provided on a straight-line basis over estimated useful lives, ranging from two to three years, and totaled $4.5 million for each of the years ended June 30, 1989 and 1988.

Investment in The Santa Cruz Operation, Inc. Other assets include the $19.9 million cost of a minority interest in The Santa Cruz Operation, Inc., acquired in May 1989. The Santa Cruz Operation is the leading developer and publisher of UNIX system software, which uses technology licensed from the Company. Related royalties are not material to the Company.

Note 6. Leases

The Company has operating leases for part of its corporate campus facilities, all international and domestic field sales and development offices, and certain data processing and other equipment. The noncancelable corporate campus lease expires in 2001 with renewal options through 2011 and provides for rental adjustments based on a consumer price index. Rental expense for operating leases was $11.4 million, $8 million, and $5.4 million during the years ended June 30, 1989, 1988, and 1987. At June 30, 1989, future minimum rental payments under noncancelable operating leases were (in thousands):

Fiscal Year	Minimum Rental Payments
1990	$14,924
1991	15,681
1992	12,146
1993	9,436
1994	5,647
1995 and thereafter	18,020
Total minimum payments	$75,854

Note 7. Notes Payable

Notes payable are borrowings under loan agreements with financial institutions, both domestic and abroad, totalling $46 million. The agreements require no compensating balances or commitment fees. A summary of these borrowings follows:

(In thousands)	1989	1988
Average month-end borrowings	$23,911	$15,817
Weighted average interest rate	9.8%	9.3%
Maximum amount outstanding during the year	$39,814	$35,322
Weighted average interest rate at year-end	9.3%	8.7%

Note 8. Income Taxes

The income tax provision (benefit) is composed of:

(In thousands)	1989	1988	1987
Current:			
Federal	$34,659	$45,034	$39,788
State	4,956	3,492	1,759
Foreign	29,741	20,644	6,855
Total current	69,356	69,170	48,402
Deferred—Federal	10,902	(9,340)	1,058
	$80,258	$59,830	$49,460

The deferred income tax provision (benefit) is composed of:

(In thousands)	1989	1988	1987
Undistributed foreign earnings	$11,187	$ 2,924	$6,332
Inventory adjustment	2,999	(5,145)	(1,127)
Reserves and expenses not currently deductible—net	(3,284)	(7,119)	(4,147)
	$10,902	$(9,340)	$1,058

The Company's effective tax rate differs from the federal rate as follows:

	1989	1988	1987
Federal statutory rate	34.0%	34.0%	46.0%
State income taxes	1.3	1.3	0.8
Tax exempt income	(1.1)	(1.1)	(1.8)
Foreign Sales Corporation	(2.0)	(1.7)	(1.1)
Tax credits	(2.5)	(1.8)	(2.8)
Other—net	2.3	1.9	(0.3)
	32.0%	32.6%	40.8%

The domestic and foreign components of income before income taxes were as follows:

(In thousands)	1989	1988	1987
Domestic	$161,122	$114,584	$ 96,705
Foreign	89,674	69,154	24,633
	$250,796	$183,738	$121,338

Note 9. Stock Option Programs

The Tax Reform Act of 1986 diminished the attractiveness of incentive stock options (ISOs) as an incentive compensation device from an income tax standpoint. During the second half of the year ended June 30, 1987, the Company responded with two programs regarding its ISOs. One program, available to employees who had exercised certain options, provides a cash payment for their undertaking a "disqualifying disposition" of stock received upon exercise of the option. A second program, available to employees who held unexercised ISOs, provided them the opportunity to convert ISOs to nonqualified stock options (NSOs), with a cash payment upon exercise of the converted options. The Company receives a tax benefit upon the disqualifying disposition or exercise, and the cash payment to employees is 50% of the Company's benefit.

As required by generally accepted accounting principles, the tax benefit realized from these programs is reported as a capital contribution. The cash payments under these programs, offset by direct income tax reduction, are recognized as expense over the vesting period of the related stock options. The effect of the programs on the accompanying financial statements was as follows:

(In thousands)	1989	1988	1987
Capital contribution	$14,098	$11,554	$24,348
Stock option program expense	$ 8,000	$14,459	$14,187
Direct income tax reduction	3,270	5,609	8,000
Reduction of net income	$ 4,730	$ 8,850	$ 6,187

Note 10. Employee Stock and Savings Plans

Employee Stock Purchase Plan. The Company has an employee stock purchase plan for all employees. Under the plan, shares of the Company's common stock may be purchased at six-month intervals at 85% of the lower of the fair market value on the first or the last day of each six-month period. Employees may purchase shares having a value not exceeding 10% of their gross compensation during an offering period. During the years ended June 30, 1989, 1988, and 1987, shares totaling 107,581, 152,179, and 68,888, respectively, were issued under the plan at average prices of $46.31, $26.53, and $12.06 per share, respectively. At June 30, 1989, 271,352 shares were reserved for future issue.

Savings Plan. The Company has a savings plan that qualifies as a cash or deferred salary arrangement under Sections 401(a) and 401(k) of the Internal Revenue Code. Under the plan, participating U.S. employees may defer up to 15% of their pre-tax salary, but not more than $7,000 per plan year. The Company contributes fifty cents for each dollar contributed by a participant, but only with respect to the first 6% of a participant's earnings (thus, the Company's maximum contribution is 3% of participant's earnings). The Company's matching contributions to the savings plan for the years ended June 30, 1989, 1988, and 1987 were $1.5 million, $1.1 million, and $557,000, respectively.

Stock Option Plan. The Company has a stock option plan for officers and key employees which provides for nonqualified and incentive options. The Board of Directors determines the option price (not to be less than fair market value for incentive options) at the date of grant. The options generally expire five or ten years from the date of grant and are exercisable over the period stated in each option. At June 30, 1989, options for 1,863,852 shares were exercisable (at an average price per share of $24.19) and 1,211,067 shares were available for future grants under the Plan.

	Outstanding Options		
		Price per Share	
	Number	Range	Weighted Average
Balance, June 30, 1986	5,019,088	$0.24 - 17.00	$ 3.26
Granted	2,114,000	13.50 - 52.50	29.11
Exercised	(1,681,582)	0.24 - 2.75	1.18
Expired	(180,104)	0.24 - 52.50	7.80
Balance, June 30, 1987	5,271,402	0.24 - 52.50	14.41
Granted	3,649,585	33.36 - 58.13	47.54
Exercised	(926,211)	0.24 - 23.88	5.10
Expired	(413,515)	0.75 - 53.50	26.88
Balance, June 30, 1988	7,581,261	0.24 - 58.13	30.82
Granted	5,264,310	44.00 - 62.75	47.66
Exercised	(1,023,549)	0.24 - 53.50	11.59
Expired	(610,903)	1.50 - 62.38	31.77
Balance, June 30, 1989	11,211,119	$0.24 - 62.75	$40.43

Note 11. Litigation

On March 17, 1988, Apple Computer, Inc. brought suit against Microsoft and Hewlett-Packard Company for alleged copyright infringement, in the U.S. District Court, Northern District of California. The complaint includes allegations that the visual displays of Microsoft Windows version 2.03 infringe Apple's copyrights and exceed the scope of a 1985 Settlement Agreement between Microsoft and Apple. The complaint seeks to enjoin Microsoft from marketing Microsoft Windows 2.03 and from otherwise infringing Apple's copyrights and seeks damages in an unspecified amount resulting from the alleged infringement. The complaint also alleges that Microsoft is a contributory infringer as to a Hewlett-Packard product called New Wave.

The Company has answered the complaint, denying Apple's allegations that the visual displays in Microsoft Windows 2.03 infringe any protectable right of Apple, raising affirmative defenses, asserting counterclaims, and seeking damages in an unspecified amount resulting from Apple's actions. In a July 25, 1989 order, the court held that: (1) The use in Windows 2.03 of visual displays that are in Windows 1.0 and the named applications programs is licensed under the 1985 Agreement. (2) The visual displays used in Windows 2.03 are in Windows 1.0 and the named applications programs, except for seven relating to the use of overlapping main application windows and three relating to the appearance and manipulation of icons. This means that 179 of the 189 Windows 2.03 visual displays, which Apple alleges are infringing, are no longer in the case.

The Company anticipates that, in the next phase of the litigation, the parties and the court will address the issues of whether the visual displays remaining in the case constitute protectable expression or are licensed under the 1985 Agreement.

In another matter, the Company and certain of its officers have been named as defendants in a lawsuit alleging violations of the federal securities laws and related state claims. The amended complaint, filed on March 24, 1989 in the U.S. District Court, Western District of Washington, alleges that the plaintiff, Stanley Grossman, and others were damaged when the market price of Microsoft common stock fell following the Company's March 7, 1989 announcement that third quarter financial results were expected to be less than what some market analysts were projecting. The Company believes the plaintiff's claims are without merit and intends to defend the case vigorously.

The Company presently believes that the resolution of these matters will not have a material adverse effect on its financial condition as reported in the accompanying financial statements.

(In thousands)

	Information by Geographic Area				
	Domestic Operations	European Operations	Other International Operations	Eliminations	Consolidated
1989					
Net revenues:					
Customers	$519,056	$212,018	$72,456	$ —	$803,530
Intercompany	60,155	121,942	13,251	(195,348)	—
Total	579,211	333,960	85,707	(195,348)	803,530
Operating income	153,047	72,952	13,186	3,045	242,230
Identifiable assets	580,425	190,466	39,400	(89,693)	720,598
1988 (1)	122563 22%	26% ↑ 85153			
Net revenues:					
Customers	$399,128	$144,825	$46,874	$ —	$590,827
Intercompany	52,520	103,982	4,357	(160,859)	—
Total	10 451,648	248,807	51,231	(160,859)	590,827
Operating income	131,246	63,210	4,950	(11,959)	187,447
Identifiable assets	398,167	150,215	26,107	(81,470)	493,019
1987	172529 38% ↑	54% ↑ 133952			
Net revenues:					
Customers	8 $252,623	$ 68,307	$24,960	$ —	$345,890
Intercompany	26,496	46,548	3,237	(76,281)	—
Total	279,119	114,855	28,197	(76,281)	345,890
Operating income	101,485	24,994	3,269	(2,861)	126,887
Identifiable assets	256,284	64,726	12,250	(45,506)	287,754

Intercompany sales between geographic areas are accounted for at prices representative of unaffiliated party transactions. "Other International Operations" includes subsidiaries in Australia, Canada, and Japan. "Domestic Operations—net revenues from customers" includes export revenues of $153.8 million, $90.6 million, and $53.0 million during the years ended June 30, 1989, 1988, and 1987. The majority of these export revenues result from OEM distribution in the Far East and Europe.

International revenues, which includes both international operations and export, were as follows:

(In thousands)	*1989*	*1988*	*1987*
European operations	*$212,018*	*$144,825*	*$ 68,307*
Other international operations	*72,456*	*46,874*	*24,960*
Export	*153,787*	*90,557*	*52,952*
	$438,261	*$282,256*	*$146,219*
Percentage of total revenues	*54.5%*	*47.8%*	*42.3%*

(1) Certain previously reported amounts have been reclassified to conform with a presentation adopted in 1989.

Microsoft Corporation Quarterly Financial and Market Information (Unaudited)

(In thousands, except per share data)

	Quarter Ended				
	Sept. 30	Dec. 31	Mar. 31	June 30	Year
1989					
Net revenues	$176,393	$209,882	$197,024	$220,231	$803,530
Operating income	52,554	69,057	57,101	63,518	242,230
Net income	36,582	47,485	41,119	45,352	170,538
Net income per share	0.65	0.85	0.73	0.80	3.03
Common stock price per share:					
High	70-1/2	54-1/4	64-3/4	61	70-1/2
Low	47-3/4	45-1/4	45-3/4	47-1/2	45-1/4
1988					
Net revenues	$102,636	$155,896	$161,823	$170,472	$590,827
Operating income	32,310	56,444	55,205	43,488	187,447
Net income	21,259	35,329	37,308	30,012	123,908
Net income per share	0.38	0.63	0.67	0.54	2.22
Common stock price per share:					
High	66-5/8	79-1/4	65-1/2	67-1/2	79-1/4
Low	44-1/4	37-1/4	49-3/4	52-3/4	37-1/4
1987					
Net revenues	$ 66,780	$ 80,985	$ 98,363	$ 99,762	$345,890
Operating income	25,605	30,910	37,914	32,458	126,887
Net income	15,824	19,697	19,100	17,257	71,878
Net income per share	0.29	0.35	0.35	0.31	1.30
Common stock price per share:					
High	15-3/4	25-5/8	49-1/2	64-1/8	64-1/8
Low	13	13-3/4	23-3/4	45-1/4	13

The Company has never paid cash dividends on its common stock. The Company's common stock is traded on the over-the-counter market and is quoted on the NASDAQ National Market System under the symbol MSFT. On July 31, 1989, there were 7,635 holders of record of the Company's common stock.

Microsoft Corporation Selected Five-year Financial Data

(In thousands, except employee and per share data)

	Year Ended June 30				
	1989	1988	1987	1986	1985
For the year					
Net revenues	$803,530	$590,827	$345,890	$197,514	$140,417
Cost of revenues	204,185	148,000	73,854	40,862	30,447
Research and development	110,220	69,776	38,076	20,523	17,108
Sales and marketing	218,997	161,614	85,070	57,668	42,512
General and administrative	27,898	23,990	22,003	17,555	9,443
Operating income	242,230	187,447	126,887	60,906	40,907
Non-operating income	16,566	10,750	8,638	5,078	1,936
Stock option program (expense)	(8,000)	(14,459)	(14,187)	—	—
Income before income taxes	250,796	183,738	121,338	65,984	42,843
Provision for income taxes	80,258	59,830	49,460	26,730	18,742
Net income	170,538	123,908	71,878	39,254	24,101
At year-end					
Current assets	468,949	345,348	213,002	147,980	52,066
Property, plant, and equipment—net	198,825	130,108	70,010	19,544	11,190
Other assets	52,824	17,563	4,742	3,215	1,808
Total assets	720,598	493,019	287,754	170,739	65,064
Liabilities	158,818	117,521	48,649	31,407	10,624
Stockholders' equity	561,780	375,498	239,105	139,332	54,440
Total liabilities and stockholders' equity	720,598	493,019	287,754	170,739	65,064
Working capital	310,131	227,827	164,353	118,452	41,442
Number of employees	4,037	2,793	1,816	1,153	910
Common stock data					
Net income per share	3.03	2.22	1.30	0.78	0.52
Book value per share	10.29	7.00	4.54	2.73	1.26
Cash and short-term investments per share	5.51	3.41	2.51	2.01	0.44
Average common and common equivalent shares outstanding	56,245	55,818	55,270	50,400	46,520
Shares outstanding at year-end	54,586	53,663	52,713	51,040	43,066
Key ratios					
Current ratio	3.0	2.9	4.4	5.0	4.9
Return on net revenues	21.2%	21.0%	20.8%	19.9%	17.2%
Return on average total assets	28.1%	31.7%	31.4%	33.3%	42.8%
Return on average stockholders' equity	36.4%	40.3%	38.0%	40.5%	56.6%
Growth percentages—increases					
Net revenues	36.0%	70.8%	75.1%	40.7%	44.0%
Net income	37.6%	72.4%	83.1%	62.9%	51.8%
Net income per share	36.5%	70.8%	66.7%	50.0%	48.6%
Book value per share	47.0%	54.2%	66.3%	116.7%	75.0%

Directors	William H. Gates	Chairman of the Board and Chief Executive Officer, Microsoft Corporation
	Jon A. Shirley	President and Chief Operating Officer, Microsoft Corporation
	David F. Marquardt	General Partner, Technology Venture Investors
	Robert D. O'Brien	Chairman of the Board, PACCAR, Inc. (retired)
	Wm. G. Reed, Jr.	Chairman, Simpson Investment Company
Officers	William H. Gates	Chairman of the Board and Chief Executive Officer
	Jon A. Shirley	President and Chief Operating Officer
	Steven A. Ballmer	Senior Vice President, Systems Software
	Jeremy Butler	Senior Vice President, International and OEM
	Francis J. Gaudette	Senior Vice President, Finance and Administration; Treasurer; Chief Financial Officer
	Scott D. Oki	Senior Vice President, USA Sales and Marketing
	Joachim Kempin	Vice President, OEM Sales and Product Support Services
	Richard C. MacIntosh	Vice President, Field Sales and Support
	Michael J. Maples	Vice President, Applications Software
	Paul A. Maritz	Vice President, Advanced Operating Systems
	William H. Neukom	Vice President, Law and Corporate Affairs; Secretary
	Bernard P. Vergnes	Vice President, Europe
	Min S. Yee	Vice President, Multimedia Division; Publisher, Microsoft Press
	Steven W. Gray	Corporate Controller

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Annual Meeting	The Annual Meeting of Shareholders will be held on Friday, October 27, 1989 at 8:00 A.M., at the Hyatt Regency Bellevue, 900 Bellevue Way NE, Bellevue, Washington.
Form 10-K	Copies of Microsoft's Annual Report on Form 10-K are available upon written request from the Investor Relations Department, Microsoft Corporation, One Microsoft Way, Redmond, Washington 98052-6399.
Common Stock	Microsoft common stock is traded over the counter on the NASDAQ National Market System (MSFT).
Independent Accountants	Deloitte Haskins & Sells, Bellevue, Washington 98004
Legal Counsel	Shidler McBroom Gates & Lucas, Seattle, Washington 98104
Transfer Agent	First Interstate Bank, Ltd., 26610 West Agoura, Calabasas, California 91302
Shareholder Inquiries	To notify Microsoft of address changes or lost certificates, shareholders can call First Interstate toll-free at (800) 522-6645.

As a Company, Microsoft is committed to the use of our technology in the workplace. Several of our products were used to create and produce this year's annual report, including both IBM and Macintosh versions of Microsoft Word, Microsoft Works, and Microsoft Excel. Information was gathered with the use of Microsoft Mail and Microsoft's XENIX®-based electronic mail system. Page composition and illustrations were developed with Aldus® PageMaker® and Aldus FreeHand™, and output on a Linotronic™ 300.

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